Digital and Digitized Assets:
Federal and State Jurisdictional Issues

The_Need_For_a_Better_CFTC_and_SEC_Regulatory_Scheme_For_Digital_Assets

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SECTION 5. THE NEED FOR A BETTER CFTC AND SEC REGULATORY SCHEME FOR DIGITAL ASSETS

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1. Introduction

The CFTC's and the SEC's authority over transactions in digital assets and derivatives involving them raises the questions of where the jurisdictional boundaries between the two agencies lie and how each agency's authority can or should be best applied to foster the public interests in vibrant, reliable markets and investor protection. The application of their separate statutes and policies can materially affect the development of the markets in digital assets and the blockchain technology that underlies them, for better or worse. Sorting out the appropriate policies to advance market vibrancy and integrity is a work-in-progress and not a simple task.

The statutes are complex; myriad different types of digital assets potentially are covered; and the current laws and regulations were not crafted with such novel and varied assets in mind. Also, because the markets for these assets developed rapidly without clear regulatory guidance, policymakers now must grapple with how these assets and the markets for them can be brought into regulatory compliance with the least harm to the markets' many participants and to beneficial financial innovation.

2. Framing the Legal and Policy Analysis

(a) The Intersection of Securities and Non-Security Commodities Transactions

The main goals of futures and swaps regulation are to facilitate use of derivatives markets for price discovery and shifting of risk, to assure the integrity of derivatives prices and their convergence with prices in the underlying cash markets, and to protect market participants from fraud and manipulation. The predominant goals of securities regulation are to facilitate capital formation and capital flows in an efficient and fair environment, assure the integrity of market valuations, and protect investors from fraud and manipulation in securities investments.[695] Despite those substantial differences in primary market focus and market regulation objectives, the boundary lines between what the CFTC regulates and what the SEC regulates can get blurred.

CFTC and SEC jurisdiction intersect in three principal ways:

When an interest underlying a derivative is a security.[696] Securities-based derivatives initially generated debate over whether securities are covered by the CEA's commodity definition—the settled answer is yes—and if so, which agency should regulate derivatives on

[695] *See generally* PHILLIP M. JOHNSON & THOMAS L. HAZEN, DERIVATIVES REGULATION § 4.05 [9], at 1014 (Wolters Kluwer 2004).

[696] The CEA uses the definition of "security" in the Securities Act and Exchange Act. *See* 7 U.S.C. § 1a(41). The CEA also defines other securities-related terms that are relevant for delineating how jurisdiction is allocated to the CFTC and SEC over security-based derivatives, including "security futures," "security futures products," "exempted securities," and a "narrow-based security index."

securities or related interests in securities.[697] As explained in Section 2.4, the current statutory framework largely resolves jurisdictional issues in this area by giving the CFTC the authority to regulate certain securities-based derivatives (*e.g.*, futures on Treasury securities or a broad-based index of equity securities), the SEC the authority to regulate others (*e.g.*, options on securities or an index of securities), and both agencies the authority to regulate one segment together (security futures products). When a commodity's classification as a security or a non-security is straightforward, the regulatory allocation scheme is relatively straightforward to apply. When it is not, as can be the case with certain digital assets, the determination as to which agency regulates derivatives on a particular token can be uncertain.[698]

When a non-security commodity or derivative is embedded in a security. The CFTC can have jurisdiction with respect to a security that has embedded characteristics of a non-security commodity or derivative, such as when the value of a security is linked to the value of a non-security commodity. Certain "hybrid securities" linked to non-security commodities may qualify for relief from CEA derivatives regulation under existing exemptions (described below). However, hybrid digital assets that are securities on the basis that they are investment contracts—*i.e.*, by virtue of how they are first offered and marketed and not because they

[697] As explained in Section 5.4, after the CEA's commodity definition was expanded in 1974 along with the establishment of the CFTC, there was initial debate over whether the amendments gave the CFTC exclusive jurisdiction over futures, options on futures, and options on securities. The current statutory framework reflects the resolution of those issues. When Dodd-Frank expanded the CEA's reach to cover swaps in 2010, it divided oversight of swaps relating to securities between the SEC and CFTC.

[698] Where the agencies allow regulated trading of derivatives on a digital asset, one can infer whether the asset is a security or a non-security commodity from the manner in which the derivative is permitted to trade. The fact that the futures exchanges list bitcoin futures as products the CFTC alone regulates and not as security futures, without SEC challenge during the very public new product review process that occurred, would seem to ratify bitcoin's status as a non-security commodity.

represent equity ownership in an entity or the promise of debt repayment as a debt security—raise special policy considerations.

When a derivative has both securities and non-security commodities as underlying reference components. Although perhaps less common, CFTC and SEC jurisdictional interests also can overlap when a derivative has both securities and non-security commodities as underlying reference values. The statutory scheme acknowledges that this permutation could occur for derivatives classified as swaps, and resolves the issue by treating so-called "mixed swaps" as both swaps that the CFTC regulates and security-based swaps that the SEC regulates.[699] Apart from this area of overlap, as between the two agencies, the CFTC alone regulates swaps and the SEC alone regulates security-based swaps.[700]

(b) Novel Characteristics of Digital Assets

The diverse terms and uses among digital assets, combined with the creativity of those developing such products, can pose unprecedented challenges for applying a jurisdictional analysis to products that involve some combination of securities characteristics with non-security commodity characteristics and/or derivatives characteristics. This is most notable for digital

[699] A mixed swap is a swap that meets the security-based swap definition in CEA section 3(a)(68)(A), and which also is "based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(iii)." 7 U.S.C. § 1a(49)(D). CEA section 1a(49)(B)(x) excludes "security-based swaps" from the swap definition, "other than a security-based swap as described in subparagraph (D)," *i.e.*, other than a mixed swap.

[700] The SEC retains enforcement authority that it possessed prior to the enactment of Dodd-Frank Act over "security-based swap agreements," which are defined as swap agreements (as defined in section 206A of the Gramm-Leach-Bliley Act) of which a material term is based on the price, yield, value or volatility of any security or any group or index of securities, including any interest therein, but does not include a security-based swap. *See* 15 U.S.C. § 78c(a)(78); 7 U.S.C. § 1a(47)(A)(v). Such security-based swap agreements may include, for example, swaps on broad-based security indicies and U.S. Treasury securities that are subject to CFTC regulatory authority. *See* Product Definitions, 77 Fed. Reg. at 48,294. However, the SEC does not have regulatory authority with respect to such swaps.

assets where the securities characteristics may be temporary. The SEC staff has recognized that some digital assets—the digital coin ether being the example offered—might begin life as a security in the form of an investment contract but over time transform into a non-security commodity.[701] The current legal framework does not anticipate this type of temporal permutation. The closest analogue would be when an index of securities may toggle between being classified as a narrow or a broad-based index, which affects the classification of certain securities-based derivatives (futures vs. security futures; swap vs. security-based swap) for purposes of applying CFTC and SEC jurisdiction.[702] For example, a security-based index may evolve from a product under the CFTC's exclusive jurisdiction to one subject to joint CFTC and SEC jurisdiction (or vice versa) as the index's composition shifts over time.[703] That

[701] Hinman, *supra* note 54. The CFTC and SEC also can share jurisdiction with the states over cash market transactions in digital assets. Most states have laws governing virtual currency businesses. *See infra* Section 8 & Appendix; *Cryptocurrency & Law: A Comprehensive Overview of 50 States' Guidance and Regulations on Blockchain and Digital Currency*, BITCOIN CENTER NEW YORK CITY (Mar. 6, 2018), https://bitcoincenternyc.com/bitcoin-news/bitcoin-blockchain-cryptocurrency-laws-50-states/. Other federal agencies such as the IRS and FinCEN have created additional regulatory considerations for market participants in the tax and money transmitter contexts, respectively. *See* I.R.S. News Release IR-2018-71, U.S. Internal Revenue Service (Mar. 23, 2018), https://www.irs.gov/newsroom/irs-reminds-taxpayers-to-report-virtual-currency-transactions (in which the IRS reminds taxpayers to report virtual currency transactions: "Taxpayers who do not properly report the income tax consequences of virtual currency transactions can be audited for those transactions and, when appropriate, can be liable for penalties and interest. In more extreme situations, taxpayers could be subject to criminal prosecution for failing to properly report the income tax consequences of virtual currency transactions."); *see also* FIN-2013-G001, *supra* note 189.

[702] The definitions of security future and security-based swap include, respectively, futures or swaps on a narrow-based security index. *See* 7 U.S.C. § 1a(44) (definition of security future); 15 U.S.C. § 78c(a)(68) (definition of security-based swap). In the Part 41 Rules for security futures products, CFTC Rule 41.14, 17 C.F.R. § 41.14, sets out tolerance period and transaction provisions for security futures on an index that ceases to be a narrow-based security index. The CEA definition of "narrow-based security index" in CFTC Rule 1.3, 17 C.F.R. § 1.3, as used in the definition of "security-based swap," includes tolerance period and grace period concepts for swaps traded on exchanges or SEFs that become security-based swaps when the index has changed to a narrow-based security index.

[703] This occurred, for example, with a futures contract offered by Eurex. In 2002, the CFTC granted no-action relief permitting Eurex to offer futures on a securities index in the United States, finding that the index met the statutory requirements for a broad-based securities index. *See* CFTC No-Action Letter No. 02-38 (Apr. 2, 2002), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/02-38.pdf. In 2011, Eurex conducted an internal review and determined that the index had transitioned to a narrow-based securities index, which it brought to the attention of the SEC and CFTC. *See* Eurex Report, *supra* note 477, at 3.

circumstance, however, effectively involves the mechanical application of the statutory requirements to known securities. In contrast, the digital asset context involves the substantive determination of when the characteristics of the sale of a non-security commodity or derivative cease to involve an investment contract, so the transition or sharing of jurisdiction between the commissions would require new rules or rule interpretations.

(c) Cash Market Trading of Digital Assets

Each agency's authority over cash market trading of *commodities* (under the broad CEA definition) should not intersect. The federal securities laws authorize the SEC, not the CFTC, to regulate initial offerings and secondary market trading of securities. As a general matter, the CFTC does not regulate cash commodity markets—it regulates derivatives markets. As one exception, the CFTC has regulatory authority over leveraged, margined, or financed retail commodity transactions under CEA section 2(c)(2)(D),[704] but that authority is expressly limited to transactions in commodities that are not securities.[705] The CFTC also construes its anti-fraud and anti-manipulation enforcement authority (but not rulemaking authority) broadly to cover contracts for the sale of commodities in interstate commerce.[706] CEA section 6(c)(1),[707] which was added as part of the Dodd-Frank Act amendments to the CEA, as relevant here, broadly prohibits any person, directly or indirectly, from using or employing, or attempting to use or

[704] 7 U.S.C. § 2(c)(2)(D). As explained in Section 2.2, transactions covered by this provision are regulated as or "as if" they are futures contracts, unless the transactions fit within an exemption. In practice, parties to such transactions try to operate within the "28 day actual delivery" exemption.

[705] *See* 7 U.S.C. § 2(c)(2)(D)(ii)(II) (expressly providing that CEA section 2(c)(2)(D) does not apply to "any security").

[706] Of course the SEC does not regulate the non-security cash commodity markets, either. Participants in these markets are not obligated to meet any of the registration and reporting requirements or business conduct standards that derivatives and securities market participants must meet. *See supra* Section 2.3(f).

[707] 7 U.S.C. § 9(c)(1).

employ, in connection with any contract of sale of any commodity in interstate commerce, any manipulative or deceptive device in contravention of any CFTC rule. CFTC Rule 180.1[708] implements this statutory prohibition. However, CEA section 2(a)(1)(H)[709] provides that the CFTC shall have no jurisdiction under the Dodd-Frank Act or any amendment to the CEA made by the Dodd-Frank Act with respect to any security other than a security-based swap.[710] This would seem to exclude from the scope of CEA section 6(c)(1) and CFTC Rule 180.1 transactions in securities.[711]

(d) Smart Contracts

Use of smart contracts as digitized representations of recognized derivatives contracts should not raise any unique issues of jurisdictional conflict between the CFTC and SEC over the derivatives.[712] The terms and conditions defining the contract are relevant for analyzing the legal

[708] 17 C.F.R. § 180.1. The CFTC's construction of CEA section 6(c)(1) and Rule 180.1 was questioned in *CFTC v. Monex Credit Co.*, 931 F.3d 966 (9th Cir. 2019), *cert. denied sub nom. Monex Deposit Co. v. CFTC*, No. 19-933, 2020 WL 3492657 (June 29, 2020). The defendants argued, and the district court agreed, that section 6(c)(1) and Rule 180.1 apply only to fraud in connection with the manipulation of a market price and not in other contexts, such as in the solicitation of commodity transactions. The district court concluded that the CFTC's construction did not comport with the legislative history of section 6(c)(1), which focused on market manipulation and did not suggest Congress intended the broad reach the CFTC ascribed to it. In reversing the district court, the Ninth Circuit held that section 6(c)(1) and Rule 180.1 applied to alleged fraud in the sale of leveraged retail commodity contracts, but the court declined to opine on the provisions' application in other contexts. Other courts, too, have applied CFTC Rule 180.1 to fraud in connection with commodity derivatives transactions that did not involve allegations of market manipulation. *See, e.g.*, *CFTC v. S. Tr. Metals, Inc.*, 880 F.3d 1252, 1262 (11th Cir. 2018); *CFTC v. Dupont*, No. 8:16-cv-03258, 2018 WL 3148532, at *8 (D.S.C. June 22, 2018) (slip op.); *McDonnell I*, 287 F. Supp. 3d at 226–27, 229–30.

[709] 7 U.S.C. § 2(a)(1)(H).

[710] Presumably, this reservation of CFTC authority refers to mixed swaps, which are both swaps under the definition and security-based swaps. *See* 7 U.S.C. §§ 1a(49)(B)(x), 1a(49)(D); *supra* note 699 and accompanying text.

[711] Given that Congress in the retail commodities transactions provision expressly excluded leveraged OTC transactions in securities from the CFTC's jurisdiction, *see supra* note 705, there would appear to be little or no basis to conclude that Congress intended for the CFTC to have any jurisdiction over non-leveraged cash securities transactions.

[712] Likewise, the use of smart contracts to track and administer performance under deferred delivery commercial merchandizing transactions should not itself be dispositive of whether the contract is within the forward contract exclusion and thus outside the scope of regulation under the CEA as a future or swap.

classification of the derivative, regardless of the medium through which they are expressed. Representing derivatives through smart contracts that administer performance obligations under the contracts of course may raise other regulatory issues, but those are outside the scope of this analysis.

(e) Terminology Challenges

When discussing potential CFTC and SEC jurisdictional issues, regulators and others typically use the term "commodity" under its commonly understood meaning as shorthand to refer to commodities that are not securities. For clarity and precision, we use the term "non-security commodity" to cover commodities that are not securities, in light of the CEA commodity definition, as that definition covers securities. As explained in Section 2.3, though, there also are possible interpretations of the scope of the CEA's commodity definition that, if accepted, would result in certain products falling outside the statutory definitions of both security and commodity. This issue to date principally affects the scope of the CFTC's enforcement authority over cash market activities.

(f) Questions Guiding Analysis of CFTC and SEC Jurisdiction

Current law recognizes that issues of jurisdictional overlap can occur between the SEC and CFTC over novel derivative products, as they have in the past, and provides a mechanism (discussed below) for the two agencies to try to resolve them when they arise. Whether through that mechanism or otherwise, the following questions may be useful for evaluating whether transactions in or involving a particular digital asset are—or should be—within the regulatory purview of the CFTC alone, the SEC alone, both agencies together, or neither agency:

1. Is the digital asset a security?
2. Does the digital asset have characteristics of both a security and a non-security commodity?

3. Does the digital asset have the initial characteristics of a security only, with the potential to transform from a security to a non-security commodity (*e.g.*, a digital asset initially offered as part of an investment contract but designed ultimately to be used as a medium of exchange)?

4. As a variation of item 3, if a digital asset is perceived to have characteristics of both a security and a non-security commodity from the outset, could the security characteristics cease in the future?

5. Does the digital asset have characteristics of both a security and a derivative related to a non-security commodity?

6. Is the digital asset an underlying interest for any contracts or transactions that are derivatives (futures, options on futures, options, swaps)?

3. The Challenging Issues Applying the Statutory Schemes to Digital Assets

The digitization of an asset principally functions as a technological wrapper for the particular unique bundle of property rights and interests each asset represents. The DAO token, the Munchee token, bitcoin, and a commodity-backed token are all digital assets, but have different features and functions. Some digital assets may be straightforward to classify as a security or a non-security commodity, such as tokens that are simply a form of electronic title for ownership of an underlying asset, say gold, where the token's status should follow that of the underlying asset.

Other tokens can be more challenging to classify for appropriate regulatory treatment. In particular, the initial offering of digital assets for capital raising and their resale in secondary markets, when they are perceived to have attributes of both securities and non-security commodities, have brought confusion and uncertainty surrounding the interplay of the agencies' jurisdictions. Tokens that are sold initially as a means to raise capital to build the platform in which the tokens will serve a utility function, *e.g.*, as a medium of exchange for the issuer's products and services, or as a store of value for investment, seemingly implicate both the CFTC's and the SEC's regulatory interests. If the SEC believes the initial or secondary market transactions constitute the purchase or sale of a security under the tests set forth in *SEC v. W.J. Howey Co.*[713] or *Gary Plastic Packaging v. Merrill Lynch, Pierce, Fenner & Smith Inc.*,[714] the SEC could assert regulatory and enforcement authority to require compliance with the federal securities laws. If the CFTC believes they are non-security commodities, it could assert jurisdiction over cash market sales of the digital asset under its anti-fraud and anti-manipulation authority or possibly under its authority over certain retail commodity transactions, but competing assertions of jurisdiction over the same cash market commodity transactions by the SEC and CFTC would be at odds with the statutory allocation of jurisdiction between them, described above.

The clarity of the existing statutory scheme is strained when a digital asset might be considered a security because it is offered to raise capital for a business enterprise but also appears to replicate the structure and terms of a future, option, or swap on a non-security commodity. For example, if the token is designed to be backed by a store of gold at a future time, has its value largely pegged to the future price of gold, can be redeemed in the future for a pro-rata share of the gold or the cash equivalent, is a margined or leveraged transaction, and can be traded on margin in a secondary market, the initial transactions in the token might look like a vehicle to speculate on the future value of gold. Is it more appropriate from a regulatory perspective to treat those transactions as securities transactions regulated by the SEC, as derivatives transactions regulated by the CFTC, or as transactions regulated concurrently by both agencies? If those creating the tokens decide to resolve the question by expressly offering them as securities, seeking to rely on the CEA exemption for hybrid securities to avoid CFTC

[713] 328 U.S. 293 (1946).

[714] 756 F.2d 230 (2d Cir. 1985).

regulation, it is fair to ask whether that exemption was really intended to cover securities that economically replicate derivatives the CFTC otherwise would regulate. On the other hand, if the token represents title to gold, the circumstances of how the transactions are offered and the nature and intention of the parties to the transaction may support the conclusion that the transactions are most appropriately treated as commercial forward contracts that neither agency regulates.

Recognizing the regulatory uncertainty that results from reliance on the *Howey* test, SEC Commissioner Hester M. Peirce has recommended that the SEC establish a safe harbor.[715] Commissioner Peirce succinctly explained the problem with the *Howey* test:

> [T]he determination of whether an instrument is offered and sold as a security in the form of an investment contract requires a subjective weighing of the facts and circumstances. Such analysis, idiosyncratic by its very nature, does not produce clear guideposts for entrepreneurs and others to follow. The challenge of discerning a clear legal line is especially difficult with respect to new forms of business and novel technologies. Entrepreneurs may be forced to choose between unpalatable options: expending their limited capital on costly legal consultation and compliance or forgoing their pursuit of innovation due to fear of becoming subject to an enforcement action. A regulatory safe harbor could resolve this unhappy dilemma.[716]

She further summarized the impediments to blockchain and digital asset innovation caused by the SEC's regulatory approach:

> We have created a regulatory Catch 22. Would-be networks cannot get their tokens out into people's hands because their tokens are potentially subject to the securities laws. However, would-be networks cannot mature into a functional or decentralized network that is not dependent upon a single person or group to carry out the essential managerial or entrepreneurial efforts unless the tokens are

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[715] Hester M. Peirce, Commissioner, SEC, Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization (Feb. 6, 2020), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06 [hereinafter SEC Commissioner Peirce Safe Harbor Proposal]; Hester M. Peirce, Commissioner, SEC, Statement on SEC Settlement Charging Token Issuer with Violation of Registration Provisions of the Securities Act of 1933 (Sept. 15, 2020), https://www.sec.gov/news/public-statement/peirce-statement-settlement-charging-token-issuer [hereinafter SEC Commissioner Peirce Statement on SEC Settlement with Unikrn, Inc.].

[716] SEC Commissioner Peirce Statement on SEC Settlement with Unikrn, Inc., *supra* note 715.

> distributed to and freely transferable among potential users, developers, and participants of the network. The securities laws cannot be ignored, but neither can we as securities regulators ignore the conundrum our laws create.[717]

To facilitate participation in and the development of functional or decentralized networks, SEC Commissioner Peirce's proposed safe harbor would provide network developers with a three-year grace exemption from the registration provisions (but not anti-fraud provisions) of the federal securities laws, so long as certain conditions are met. The proposed conditions would be that the offeror's initial development team must:

- Intend for the network on which the token functions to reach network maturity—defined as either decentralization or token functionality—within three years of the date of the first token sale and undertake good faith and reasonable efforts to achieve that goal;
- Disclose key information on a freely accessible public website;
- Undertake good faith and reasonable efforts to create liquidity for users;
- File a notice of reliance; and
- Offer and sell the token for the purpose of facilitating access to, participation on, or the development of the network.[718]

To date, the SEC has not taken any action on Commissioner Peirce's proposed safe harbor.

On the CFTC side, CFTC Chairman Heath Tarbert has informally suggested that the CFTC will not treat a digital asset as a commodity until it is determined not to be a security. In his remarks at the Yahoo! Finance All Markets Summit in October 2019 discussing Ethereum, Libra, and the treatment of forks, Chairman Tarbert explained that the legal analysis begins with the question of "[i]s it [a digital asset] a security, first and foremost," and "if it isn't a security, it

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[717] SEC Commissioner Peirce Safe Harbor Proposal, *supra* note 715.

[718] *Id.*

is most likely a commodity."[719] He remarked that the CFTC worked with the SEC on Bitcoin and Ethereum and that the agencies agreed neither are securities. Chairman Tarbert further suggested that the CFTC may allow ether futures to trade on U.S. markets.[720] He expressed the same view with respect to forks: "It stands to reason that similar assets should be treated similarly. If the underlying asset, the original digital asset, hasn't been determined to be a security and is therefore a commodity, most likely the forked asset will be the same. Unless the fork itself raises some securities law issues under that classic *Howey* test."[721]

These principles, pursuant to which the CFTC apparently will defer to the SEC's jurisdiction where the SEC views a transaction as a security under the *Howey* test, may limit potential friction between the agencies in regulatory actions but do not ultimately resolve the legal and jurisdictional overlap. The views of a CFTC Chairman, while consequential to the work of the agency during his or her term, are not binding on the Commission and have no force of law. In addition, the apparent premise that the CFTC would lack jurisdiction if a security is involved is not necessarily supported by the terms of the CEA or the federal securities laws. As explained in this Section (and Section 2), the CEA's definition of "commodity" includes securities. The fact that a non-security commodity can be classified as a security interest in a

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[719] *CFTC Chairman Heath Tarbert has said ether, the world's second-largest cryptocurrency by market capitalization, is a commodity*, COINDESK (Oct. 10, 2019), https://www.coindesk.com/cftc-chairman-confirms-ether-cryptocurrency-is-a-commodity [hereinafter Coindesk article].

[720] *Id.* Chairman Tarbert said: "We've been very clear on bitcoin: bitcoin is a commodity. We haven't said anything about ether—until now. It is my view as chairman of the CFTC that ether is a commodity." *Id.*; *see also* Heath P. Tarbert, Chairman, CFTC, Statement of Chairman Heath P. Tarbert in Support of Interpretive Guidance on Actual Delivery for Digital Assets n.3 (Mar. 24, 2020), https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement032420a (citing Heath P. Tarbert, Chairman, CFTC, Interview at Yahoo! Finance All Markets Summit (Oct. 10, 2019) [hereinafter Yahoo! Interview] (stating belief that current version of ether is a commodity)).

[721] Coindesk article, *supra* note 719.

common enterprise under *Howey* based on how the transaction is structured and marketed does not necessarily oust the CEA's application to the commodity or the transaction.

Several congressional bills have proposed legislation seeking to resolve the jurisdictional uncertainty between the CFTC and the SEC with respect to digital assets. In March 2020, U.S. Representative Paul A. Gosar of Arizona introduced the Crypto-Currency Act of 2020, which seeks to resolve jurisdictional boundaries by establishing three categories of digital assets—"crypto-commodities," "crypto-currencies," and "crypto-securities"—and dividing primary jurisdiction over them among the CFTC, FinCEN, and the SEC.[722] It provides that the CFTC shall be the primary agency with the authority to regulate crypto-commodities; the Secretary of the Treasury, acting through the FinCEN, and the Comptroller of the Currency shall be the primary agencies with the authority to regulate cryptocurrencies (other than synthetic stablecoins); and the SEC shall be the primary agency with the authority to regulate crypto-securities and synthetic stablecoins.[723]

How the primary jurisdiction of each agency would operate in practice is not clear, however, because any one digital asset would appear to fit within more than one of the three statutory product definitions (*e.g.*, a cryptocurrency also could be a crypto-commodity); the bill defines the three categories as follows:

- "Crypto-commodity" means "economic goods or services, including derivatives, that—(A) have full or substantial fungibility; (B) the markets treat with no regard as to who produced the goods or services; and (C) rest on a blockchain or decentralized cryptographic ledger."

[722] *See* Crypto-Currency Act of 2020, H.R. 6154, 116th Cong. § 2 (2d Sess. 2020), https://www.congress.gov/bill/116th-congress/house-bill/6154/text?q=%7B%22search%22%3A%5B%22crypto-currency+act%22%5D%7D&r=1&s=2.

[723] *Id.*

- "Crypto-currency" means "representations of United States currency or synthetic derivatives resting on a blockchain or decentralized cryptographic ledger, including—(A) such representations or synthetic derivatives that are reserve-backed digital assets that are fully collateralized in a correspondent banking account, such as stablecoins; and (B) synthetic derivatives that are—(i) determined by decentralized oracles or smart contracts; and (ii) collateralized by crypto-commodities, other crypto-currencies, or crypto-securities."

- "Crypto-security" means "all debt and equity that rest on a blockchain or decentralized cryptographic ledger," except the term does not include a synthetic derivative that (i) is operated as, and is registered with the Department of the Treasury as, a money services business (as defined under 31 C.F.R. § 1010.100); and (ii) is operated in compliance with all applicable requirements of the Bank Secrecy Act and all other federal anti-money laundering, anti-terrorism, and screening requirements of the Office of Foreign Assets Control and FinCEN.

In September 2020, Representative K. Michael Conaway of Texas introduced the Digital Commodity Exchange Act of 2020 (DCEA),[724] which is designed to fill the regulatory gaps that exist between the CFTC and the SEC. The DCEA creates a new statutory scheme within the CEA for transactions in a "digital commodity," which the bill defines to be "any form of fungible intangible personal property that can be exclusively possessed and transferred person to person without necessary reliance on an intermediary, and which does not represent a financial interest in a company, partnership, or investment vehicle."[725] The DCEA principally addresses four areas:

(1) **Spot and margin exchange trading in digital commodities**. The DCEA provides for the voluntary registration with the CFTC of exchanges for the spot purchase and sale of digital commodities. The bill denominates such registered entities as Digital Commodity Exchanges (DCEs) and confers exclusive jurisdiction on the CFTC with respect to transactions subject to the rules of a DCE or any other CFTC registered entity. The DCEA requires that for an exchange to be approved for registration, it must demonstrate the ability to comply with many financial, governance, customer protection, and market protection requirements. It also authorizes the CFTC to promulgate and

[724] Digital Commodity Exchange Act of 2020, H.R. [unnumbered], 116th Cong. (2d Sess. 2020), https://republicans-agriculture.house.gov/uploadedfiles/final_-_digitalcea_xml.pdf.

[725] *Id.* § 2.

enforce rules governing margin trading on DCEs. This registration is entirely voluntary—an exchange must affirmatively opt to become CFTC regulated before the law will apply. The statutory scheme incentivizes regulation, however, by, among other things, preempting the application of state money transmitter laws for registered DCEs.

(2) **Off-exchange retail digital commodity transactions**. The DCEA amends the retail commodity transactions provision in CEA section 2(c)(2)(D) to exclude contracts of sale of digital commodities that (a) result in actual delivery within two days or such other period as the CFTC determines, or (b) are executed on or subject to the rules of a DCE.

(3) **Custody of digital commodities**. The DCEA provides for the CFTC designation of custodians of digital commodities as "Qualified Digital Commodity Custodians" if the CFTC finds that the custodian is subject to adequate supervision and appropriate regulation by a state, federal, or international banking regulator.

(4) **Sales of digital commodities acquired in securities offerings**. The DCEA does not change the application of the federal securities laws to the "presale" of digital commodities in connection with raising money to fund a digital commodity project. The DCEA, however, endeavors to establish a bright line for when a digital commodity that was "presold" as part of a securities offering may be lawfully resold by the owner. To this end, it confers exclusive jurisdiction on the CFTC "over any agreement, contract, or transaction involving a unit of a digital commodity, or any promise or right to a future unit of a digital commodity, obtained through a digital commodity presale and subject to the restrictions in section 4c(h)" (which the DCEA would add to the CEA).[726]

The DCEA would permit the sale or transfer of a digital commodity acquired in a securities offering in these instances:

- to another person who would have been eligible for the relevant securities offering;
- on a registered DCE;
- to utilize the digital commodity for its intended commercial purpose; or
- under a limited CFTC-provided public interest exemption.[727]

[726] *See id.*

[727] *See id.*

Under the DCEA, once a unit of a digital commodity is sold through a registered DCE, all trading restrictions on the asset are removed, and it becomes freely usable by any market participant for any purpose.[728]

The regulatory uncertainty and ambiguity attending digital assets, unless and until addressed by legislation such as the DCEA, have the potential to frustrate enforcement of the laws. The agencies appear to have coordinated the use of their respective resources to combat perceived fraudulent activity in connection with cash market transactions in digital assets, such that in some circumstances only one agency has initiated action to protect potential victims and the public interest. In the absence of clear public statements to the contrary, however, their coordination does not necessarily mean that, where only one agency initiates an action, only that agency has determined that it has jurisdiction.[729] When a digital asset straddles classification as a security or a non-security commodity, the risk that both the SEC and the CFTC could choose to assert their respective anti-fraud enforcement powers undermines the asserting agency's jurisdictional position. If either agency initiates an enforcement action for suspected fraud in connection with cash market sales of digital assets, but the manner in which the digital asset is marketed to purchasers arguably brings it within the definition of a security as an investment

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[728] *See id.*

[729] In 2018, Attorney General Jeff Sessions established a Cyber-Digital Task Force within the U.S. Department of Justice to evaluate the impact that recent advances in technology have had on law enforcement's ability to keep U.S. citizens safe. The Task Force issued a comprehensive report later that year that identified particular threats confronting the United States, ranging from transnational criminal enterprises' sophisticated cyber-enabled schemes to malign foreign influence operations to efforts to compromise critical infrastructure. The report also identified a number of emerging threats whose contours were still developing and recommended further examination of their potential impact. DOJ, REPORT OF THE ATTORNEY GENERAL'S CYBER-DIGITAL TASK FORCE 126 (July 2018), https://www.justice.gov/cyberreport. On October 20, 2020, the Task Force issued its second report detailing the enforcement framework for combating cyber-digital threats. The report included discussion of the CFTC and SEC enforcement efforts in the area but did not address the jurisdictional uncertainty between them. DOJ, REPORT OF THE ATTORNEY GENERAL'S CYBER-DIGITAL TASK FORCE (Oct. 2020), https://www.justice.gov/ag/page/file/1326061/download.

contract, sorting out the proper scope of each agency's authority through the courts could frustrate the timely enforcement of either agency's authority.[730]

From the perspective of creators and purveyors of such assets, the uncertainty could frustrate or overwhelm the commercial viability of the enterprise. The regulatory complexity and uncertainty are especially acute for digital assets that over time are deemed to morph from a security to a non-security commodity. Ether is the only example of an asset the SEC staff has identified that may have been a security when initially offered and later transformed into a non-security commodity. It bears noting, however, that as a practical matter, ether's acceptance and use might not have happened if the securities law requirements for transfers of securities (*e.g.*, requiring broker-dealers to act as intermediaries) had been observed. This implicates a key issue for the commercial practicality of the views of SEC staff: how will it be feasible for a digital asset that is intended to function as a medium of exchange to fulfill that function if its transfer from one owner to another must comply with restrictions on the purchase and sale of securities or can only be facilitated by persons that are registered (as appropriate to the roles they perform) as broker-dealers, exchanges, clearing agencies, or transfer agents? Even if, for example, the

[730] There are instances in which the CFTC and SEC have brought parallel enforcement actions against the same exchange, but with each agency limiting its action to different products. As alleged in the agencies' respective settlement orders in *In re Plutus Financial, Inc. (d/b/a Abra) and Plutus Technologies Philippines Corp. (d/b/a Abra International)*, CFTC Docket No. 20-23, 2020 WL 4012173 (July 13, 2020), and *In the Matter of Plutus Financial, Inc. (d/b/a Abra) and Plutus Technologies Philippines Corp.*, Admin. Proceeding No. 3-19873, 2020 WL 4091075 (July 13, 2020), a Philippines-based trading entity was sanctioned for entering into financial transactions with U.S. and non-U.S. customers who were not ECPs. The transactions allowed the customers to gain exposure to price movements of virtual and foreign currencies, stocks, and ETFs. The CFTC found the transactions based on virtual currencies (and currencies) to be swaps that violated CEA sections 2(e) and 4(d)(1) because the counterparty customers were non-ECPs and the trading entity was not registered as an FCM. The SEC found the transactions based on stocks and ETFs to be security-based swaps that violated Securities Act section 5(e) because the counterparty customers were non-ECPs, and violated section 6(l) of the Exchange Act because the transactions were not effected on a registered national securities exchange. Significantly, the agencies asserted jurisdiction over transactions between the non-U.S. Philippines trading entity and non-U.S. customers because an affiliated entity in the United States set the price for the swaps, established the hedging mechanism for the Philippines affiliate, and performed other managerial functions related to the contracts.

initial offering of the asset is made in compliance with securities private placement rules, the securities law resale restrictions effectively would seem to prevent the asset from being serviceable for purchasing goods and services, thereby blocking its evolution to non-security status and killing the enterprise.

Even assuming that the asset could reach a point to be considered transformed into a non-security commodity, there are major regulatory impediments that have yet to be addressed. For example, when and how is it to be determined that the transformation to a non-security commodity has occurred? How does the transformation affect the enforcement authority of each agency and the states and any private claims? With more experience, clearer standards may be established with respect to when a digital asset will be deemed a security or a non-security commodity, and a less complicated regulatory regime might emerge that establishes clear and commercially reasonable lines for the treatment of digital assets.

Digital assets that from inception are backed by a non-security commodity, but that do not confer on the holder any ownership rights in the commodity, also may raise interpretive jurisdictional issues. Such instruments may draw a comparison to commodity-based ETFs, suggesting they should be treated as securities, but commodity-based ETFs are intentionally offered as investments representing share ownership in fund vehicles. It is worth recalling that when commodity-based ETFs first emerged, they presented the novel issue of whether it was more appropriate to treat ETF shares as securities or as non-security commodities when their value as an investment derived solely from changes in the value of the non-security commodities that the ETFs passively held. The CFTC granted exemptions pursuant to its authority under CEA section 4(c) to permit options on such ETFs to trade as listed securities on markets regulated by the SEC and futures on the ETFs to trade as security futures it would jointly regulate with the

SEC, on the basis that the products would be appropriately regulated. The CFTC did not take a formal position as to whether the ETFs should be viewed as securities or non-security commodities.

ETFs have been around for years now, and commodity-based ETFs are commonly known as a type of security and today probably are covered under that element of the definition in the federal securities laws.[731] Yet it does not follow that digital assets backed by non-redeemable commodity holdings and linked to price changes in such non-security commodities necessarily are securities. Tokens of that type should be evaluated based on their own merits, in terms of how they are structured, the manner in which they are offered, and the functions and features they possess. The issue is not simply whether such a token is a security or a non-security commodity. Linking the price of the token to the price of a non-security commodity evokes the implicit expectation that the token's price will have some correlation to the prevailing price for the commodity. This raises questions regarding whether the token should be viewed as a form of cash-settled derivative on the commodity, and if so, whether the token fits within any of the CEA's existing classifications for derivatives regulated by the CFTC. Alternatively, where the link is intended to provide pricing stability to facilitate acceptance of the token as a means of exchange to pay for goods or services, perhaps the currency-related function should define the token as a non-security commodity in its own right, and not as a derivative on the referenced commodity.

Securities with embedded derivatives elements are another area where CFTC and SEC jurisdiction can intersect. The existing landscape provides some clarity for hybrid securities that

[731] The definitions of "security" in Securities Act section 2(a)(1) and Exchange Act section 3(a)(10) include a "catchall" element covering any "instrument commonly known as a 'security.'" 15 U.S.C. § 77b(a)(1); *id.* § 78c(a)(10).

remain securities, through exemptions from CFTC regulation available under CEA section 2(f) or under the CFTC Part 34 Rules. CEA section 2(f) provides one exemption for hybrid instruments that are "predominantly securities." For an instrument to meet the predominance test, the purchaser must fully pay for the security, without any obligation to make additional payments such as margin or mark-to-market settlement, throughout the lifespan or at maturity of the security, and the hybrid security must not be marketed as a futures or options on futures contract subject to the CEA. The CFTC Part 34 Rules provide another exemption, which is limited to securities that are debt or equity securities[732] and also imposes the "fully paid for" requirement and marketing restriction. In addition, the exemption assumes that the security has both commodity dependent and commodity independent components, and requires the value of the commodity dependent component(s) to be less than the value of the commodity independent component.

It is appropriate to question whether it makes sense to apply the more lenient terms of the CEA hybrid securities exemption to digital assets that may be securities on the basis of being an investment contract and that also have characteristics of derivatives the CFTC regulates. In practical terms, this issue may not arise, as the CEA exemption (and likewise the Part 34 exemption) would not be available for a digital asset where it is envisioned that the token will cease to be a security at some future time and continue life as a non-security commodity, because the exemption is predicated on the instrument retaining its security status at all times. But if an issuer were willing to do so, should it be allowed to keep the "security" label to claim the CEA exemption on the digital asset after the securities characteristics disappear? When the "entrepreneurial or managerial efforts of others" are difficult to quantify and the non-security

[732] The exemption also covers certain banking products, such as demand deposits or time deposits.

commodity and commodity derivatives characteristics dominate or may in the future dominate, it would seem there is a strong policy justification for CFTC jurisdiction. The commodity-based ETF precedent suggests that hybrid digital assets of this type should not be pigeonholed into the CEA section 2(f) exemption, but instead should be addressed through coordination between the two agencies and the CFTC's exercise of its judgment regarding whether it is appropriate to exercise its exemptive authority under CEA section 4(c) to accommodate trading of derivatives on such digital assets.

Putting aside the foregoing issue, it is reasonable to foresee interest in offering debt or equity securities where one or more payment components are linked in whole or in part to the value of a virtual currency or other digital asset. In this hybrid security context, the issue, of course, is whether the digital asset is a non-security commodity. If it is, it will be important for the issuer to understand the terms of the hybrid security exemptions if it wants to qualify for relief from CEA regulation.

There are other interpretive issues that may impede development of the digital asset markets. For example, the definition of security in the ICA (and the IAA) is broader than the one used in the Securities Act, Exchange Act, and CEA, raising the prospect that a digital asset could be a non-security commodity under the CEA and yet be pulled into the realm of investment company regulation of a commodity fund holding the asset in its portfolio.

4. The History of Resolving Jurisdictional Issues between the SEC and CFTC

Issues of jurisdictional overlap between the SEC and CFTC are not new. The legal scheme today recognizes the value of cooperation between the two agencies, reflecting lessons learned from the history of resolving such issues.

In the earlier part of this history, jurisdictional questions between the CFTC and SEC over the application of their respective statutes to various financial products were debated in the courts. Those controversies generally were resolved through negotiated outcomes between the agencies, some of which later were enacted into law. Shortly after passage of the Commodity Futures Trading Commission Act of 1974, which provided the CFTC with "exclusive jurisdiction" over futures on commodities in CEA section 2(a)(1) under a newly expanded "commodity" definition, the SEC asserted that the CEA amendments had not diminished its jurisdiction over transactions involving a security—even with respect to futures contracts that involved securities.[733]

Not long thereafter, when the Chicago Board of Trade (CBOT) was preparing to list and trade a futures contract on Government National Mortgage Association (GNMA) certificates, the SEC warned that trading that contract might be illegal, notwithstanding the CFTC's prior approval. The CBOT initiated trading anyway, and the SEC took no formal action against the exchange. In 1981, however, when the SEC granted permission to the Chicago Board Options Exchange (Cboe) to trade options on GNMA certificates, the CBOT sued the SEC, arguing that a GNMA certificate was a commodity under the CEA, and the CFTC therefore had exclusive jurisdiction. The CFTC and SEC, through their respective chairmen, Philip Johnson for the CFTC and John Shad for the SEC, negotiated a resolution in what is known as the "Shad-Johnson Accord" ("Accord") that delineated the statutory applications to specific types of traded instruments. Because Congress had not yet enacted the Accord into law, the Seventh Circuit Court of Appeals did not consider it and instead held that GNMA certificates were commodities, that the CFTC had exclusive jurisdiction over GNMA options, and that the SEC had no power to authorize their trading on the Cboe.[734] Later, following Congress's enactment of the Accord into

[733] JOHNSON & HAZEN, *supra* note 695, at § 4.05[8].

[734] *Bd. of Trade of Chi. v. SEC*, 677 F.2d 1137 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982).

law as part of the Futures Trading Act of 1982,[735] options on GNMA certificates were treated as options directly on securities over which the SEC exercised jurisdiction, but futures contracts and options on futures contracts on GNMA certificates (and more generally on exempted securities, as defined in the Exchange Act) were subject to CFTC jurisdiction.

A similar controversy arose in 1988 when three securities exchanges filed applications to permit exchange trading in what were called "stock index participation" instruments. These instruments were perceived to have many characteristics of futures contracts. Significantly, the CFTC took the position that the index participation instruments were not securities and therefore should be regulated by the CFTC as futures contracts. When the SEC granted the securities exchanges' applications to list these products for trading, the CME challenged the SEC before the Seventh Circuit. That court found that the index participation instruments potentially could be classified as both securities and futures contracts, but concluded that based on the jurisdictional Accord, an instrument that can be classified as both a security and futures contract was subject to the exclusive jurisdiction of the CFTC.[736] Consequently, the instruments could not trade on the securities exchanges without CFTC approval.

Additional jurisdictional controversies continued to arise into the early 1990s. Proposed legislation in 1991 sought to further delineate the jurisdiction between the CFTC and SEC over certain hybrid investment vehicles, including securities whose values were tied to the market price of another asset or commodity. The legislation ultimately did not include a jurisdictional

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[735] Pub. L. No. 97-444, 96 Stat. 2294 (Jan. 11, 1983).

[736] *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537 (7th Cir. 1989).

allocation between the agencies. Rather, the 1992 amendments to the CEA gave the CFTC in new section 4(c)[737] authority to exempt transactions from the requirements of the CEA.

One of the CFTC's first uses of its authority under CEA section 4(c) related to the instruments that spawned the need for the authority—hybrid instruments. The CFTC crafted the Part 34 exemption (discussed above), covering hybrid instruments that are equity or debt securities or depository instruments with one or more commodity-dependent components that have payment features similar to commodity futures or commodity option contracts or combinations thereof. In the Commodity Futures Modernization Act of 2000 (CFMA), Congress added CEA section 2(f) to provide a statutory exclusion for hybrid securities that are predominantly securities (but on more lenient terms than set out in the CFTC exemption).

The CFMA also sought to resolve a jurisdictional controversy between the CFTC and SEC over the trading of futures on a single non-exempt security or a narrow-based security index. How to allocate jurisdiction over such products was one issue that the Accord left unresolved; the Futures Trading Act of 1982 banned trading of such products, but the ban was intended to be temporary. The CFMA established a structure for joint CFTC and SEC jurisdiction over those products, which is set out in CEA section 2(a)(1)(C).[738]

Points of jurisdictional overlap do not always result in disputes, as the more recent history illustrates. The two agencies cooperated to work out an approach for handling commodity-based ETFs in 2008. A number of these vehicles are structured as trusts that passively hold commodities, with the objective that the share prices would track the prices of the underlying commodities. The registration statement for the first product of this type—a gold

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[737] 7 U.S.C. § 6(c).

[738] *Id.* § 2(a)(1)(C).

ETF—was making slow progress through the SEC, as staff rightly anticipated that exchanges would want to list options and futures on the ETF shares, raising the issue of whether such derivatives should be regulated by the CFTC as commodity options and as futures, or by the SEC as options on securities and by the CFTC and SEC jointly as security futures. The exchanges in fact did pursue listing of such derivatives on shares of the gold ETF, which brought the issue before both agencies.

The CFTC and SEC entered into an MOU in March 2008 setting out an approach for addressing novel derivatives products that "may reflect elements of both securities and commodity futures or options, and may impact the regulatory mission of each agency."[739] Shortly thereafter, the CFTC exercised its exemptive authority under CEA section 4(c) to permit options on the ETF shares to be traded on national securities exchanges as options on securities and futures on such ETF shares to be traded on exchanges as security futures.[740] In its orders, the CFTC did not take a position on whether the ETF shares should be considered a security or a non-security commodity, but instead determined that the exemption would be consistent with the public interest, in large part because the products would be subject to regulation by the SEC or, for the futures, jointly by the SEC and CFTC.

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[739] CFTC & SEC, MEMORANDUM OF UNDERSTANDING BETWEEN THE U.S. SECURITIES AND EXCHANGE COMMISSION AND THE U.S. COMMODITY FUTURES TRADING COMMISSION REGARDING COORDINATION IN AREAS OF COMMON REGULATORY INTEREST (2008), https://www.sec.gov/news/press/2008/2008-40_mou.pdf; CFTC & SEC, ADDENDUM TO CFTC—SEC MEMORANDUM OF UNDERSTANDING REGARDING COORDINATION IN AREAS OF COMMON REGULATORY INTEREST: PRINCIPLES GOVERNING THE REVIEW OF NOVEL DERIVATIVE PRODUCTS (2008), https://www.skadden.com/-/media/files/publications/2018/07/fn3b_addendumtomouprinciples.pdf?la=en.

[740] *See, e.g.*, SPDR Exemption Order, 73 Fed. Reg. 31,981; CFTC Order Exempting the Trading and Clearing of Certain Products Related to SPDR Gold Trust Shares, 73 Fed. Reg. 21,917 (proposed Apr. 28, 2008) (permitting options on SPDR Gold Trust Shares to be listed by securities exchanges and cleared by Options Clearing Corporation as options on securities).

Following that cooperation, in a joint report in 2009, the CFTC and the SEC recommended legislation that would provide a process for expedited judicial review of jurisdictional matters regarding new products.[741] The report grew out of a joint meeting of the two Commissions and 30 public panelist members, including industry experts and market participants. Among other issues, panelists commented about the past jurisdictional disagreements between the CFTC and SEC over particular products due to uncertainty as to their proper regulatory classifications: a securities product would be subject to SEC jurisdiction, and a derivatives product to CFTC jurisdiction. That uncertainty, in turn, occasionally caused lengthy delays in bringing new products to market, such as the gold ETF discussed above. Despite the Commissions' entry into the 2008 MOU,[742] panelists advocated a legislative solution to more clearly define the jurisdictional boundaries between the two agencies and establish procedures to promptly resolve jurisdictional issues.

In their joint report, the agencies concurred with panelists that legislation was necessary with respect to jurisdictional matters regarding novel products. Specifically, the joint report called for (i) a review process to ensure that the Commissions resolve any jurisdictional dispute against a firm timeline and (ii) legal certainty with respect to the agencies' authority over

[741] CFTC & SEC, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION (Oct. 16, 2009), https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/ifdocs/opacftc-secfinaljointreport101.pdf.

[742] The Commissions recently updated the MOU to cover swaps and security-based swaps. *See* CFTC & SEC, MEMORANDUM OF UNDERSTANDING BETWEEN THE U.S. SECURITIES AND EXCHANGE COMMISSION AND THE U.S. COMMODITY FUTURES TRADING COMMISSION REGARDING COORDINATION IN AREAS OF COMMON REGULATORY INTEREST AND INFORMATION SHARING (July 11, 2018), https://www.cftc.gov/sites/default/files/2018-07/CFTC_MOU_InformationSharing062818.pdf [hereinafter CFTC-SEC Information Sharing MOU].

products exempted by the other agency.[743] Congress addressed the report's recommendations in Dodd-Frank,[744] enacting the first proposal in section 718 and the second in section 717.

As a more recent expression of cooperation, the CFTC and SEC entered into an MOU in July 2018 that updates the 2008 MOU.[745] The new MOU is predicated on their joint acknowledgment that "enhanced coordination and cooperation concerning issues of common regulatory interest is necessary in order to foster market innovation and fair competition and to promote efficiency in regulatory oversight."[746]

5. Statutory Process for Seeking Regulatory Clarity for Novel Derivative Products

Section 718 of Dodd-Frank establishes a procedure for the CFTC and SEC to determine the status of "novel derivative products" that might implicate the regulatory interests of both agencies. Under section 718(a)(1)(A), any person filing a proposal to list or trade a novel derivative product that may have elements of both securities and futures contracts, options on futures, or commodity options may concurrently provide notice and furnish a copy of such filing to the SEC and CFTC.[747] The notice must state it has been made to both agencies. If no concurrent notice is made, section 718(a)(1)(B) provides, as an alternative, that if either Commission receives a proposal to list or trade a product and determines that the proposal involves a novel derivative product that may implicate the jurisdiction of the other, it must within

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[743] *Id.* at 11.

[744] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[745] CFTC & SEC, MEMORANDUM OF UNDERSTANDING BETWEEN THE U.S. SECURITIES AND EXCHANGE COMMISSION AND THE U.S. COMMODITY FUTURES TRADING COMMISSION REGARDING COORDINATION IN AREAS OF COMMON REGULATORY INTEREST AND INFORMATION SHARING (July 11, 2018), https://www.cftc.gov/sites/default/files/2018-07/CFTC_MOU_InformationSharing062818.pdf.

[746] *Id.* at 1.

[747] 15 U.S.C. § 8306(a)(1)(A).

five business days of making that determination notify and provide a copy of the proposal to the other Commission.[748]

Not later than 21 days after receipt of a notice under Dodd-Frank section 718(a)(1), or upon its own initiative if no notice is received, the CFTC pursuant to section 718(a)(2) may request in writing that the SEC issue a determination as to whether a product is a "security," as defined in Exchange Act section 3(a)(10).[749] Similarly, the SEC, within 21 days after receipt of a notice under section 718(a)(1), or upon its own initiative if no such notice is received, may request in writing that the CFTC issue a determination as to whether a product is a futures contract, an option on futures, or a commodity option.[750] In addition, the CFTC and SEC may request that the other agency issue an exemption with respect to a novel derivative product pursuant to their respective exemptive authorities under CEA section 4(c)[751] and Exchange Act section 36.[752]

Once a written request for a determination or exemption is made, the requested agency shall by order issue the requested determination and the reasons therefor, or grant an exemption or provide reasons for not granting an exemption, not later than 120 days after the date of receipt of such a request.[753] Determinations by one agency that a novel derivative product is a security or a futures contract, option on futures, or commodity option (but not exemptions) are subject to

[748] *Id.* § 8306(a)(1)(B).

[749] *Id.* § 78c(a)(10).

[750] *Id.* § 8306(a)(2).

[751] 7 U.S.C. § 6(c).

[752] 15 U.S.C. § 78(mm).

[753] *Id.* § 8306(a)(3).

judicial challenge by the other agency in the U.S. Court of Appeals for the District of Columbia Circuit.[754] The court of appeals must review such a petition on an expedited basis and, in considering such a petition, must not give deference to, or any presumption in favor of, the views of either Commission.

Section 717 of Dodd-Frank amended the CEA and the Exchange Act to clarify that even if the CFTC or the SEC exempts a novel derivative product, the exempting Commission still retains jurisdiction over the product in certain cases. Specifically, Dodd-Frank section 717(a) amended CEA section 2(a)(1)(C)[755] to provide that the CFTC has jurisdiction over a product that has been exempted by the SEC from the Exchange Act with the condition that the SEC exercise concurrent jurisdiction over the product. Similarly, Dodd-Frank section 717(b) added section 3B to the Exchange Act[756] to provide that the securities laws govern as a security any agreement, contract, or transaction (or class thereof) that has been exempted by the CFTC from the CEA with the condition that the CFTC exercise concurrent jurisdiction over such agreement, contract, or transaction (or class thereof).

6. Potential Approaches to Resolving Jurisdictional Issues without New Legislation

The CFTC's and SEC's principal statutory tools to resolve jurisdictional questions without resorting to new legislation—section 718 of Dodd-Frank covering "novel derivative products" and exemptive authority under CEA section 4(c) and Exchange Act section 36—give the agencies extensive freedom to craft solutions.[757] They confer authority to exempt any

[754] *Id.* § 8306(b).

[755] 7 U.S.C. § 2(a)(1)(C).

[756] 15 U.S.C. § 78c-2.

[757] The SEC has additional and similar exemptive authority under the other statutes it administers, *e.g.*, Securities Act section 28 and section 6(c) of the Investment Company Act of 1940.

product, transaction, or person, or any class of each, from any and all provisions of their statutes, unconditionally or conditionally, and retroactively, prospectively, or both. The freedom this allows, however, does not diminish the difficulty of exercising that exemptive authority to constrain power or effectively cede power to the other agency. Those decisions take time and great deliberation if it is difficult for either agency to reach a level of confidence that an alteration of the exercise of its power will not harm the interests of those whom the statutes are intended to protect. The examples of CFTC exemptive relief discussed above concerning hybrid securities and ETFs on commodities required an extensive period of review and careful agency attention before approval.

Digital assets present a more complex set of issues due to their varied characteristics and the capacity of some to change from securities to non-security commodities. But the exemptive or section 718 processes provide a potential context by which broader and more developed regulatory guidance can be provided to the public. To date, most of the guidance has come in the form of one-off enforcement settlements or court complaints that sometimes, given the complexity of the subject matter, can raise more questions than they answer, especially with respect to application of the announced principles or reasoning to transactions with features different from those that were the subject of the settlement or complaint.

Before determining a prudent use of exemptive authority, the agencies may need to develop a shared understanding of the different types of transactions and uses of digital assets and sort out their respective interests in each type. For example, for one of the problematic jurisdictional areas—a transaction like that described in the SEC's order in *In re Munchee LLC*, in which a putative virtual currency (*i.e.*, a putative commodity) underlies an investment contract but provides no equity interest in the enterprise—the agencies may need to consider their respective interests at each stage of the issuing enterprise's development. The SEC's interest may be paramount and the CFTC's remote at the outset, when an enterprise is offering the virtual currency for initial sale and promoting its potential appreciation in value over time in a secondary market, but the virtual currency has little if any active secondary market. In that instance, reliance on the SEC's authority alone might be adequate to address the public interest and market integrity. However, in the event the virtual currency develops into an active secondary market, the CFTC's interest might become paramount, and the SEC's interest may wane because the sale of investment contracts will have concluded.

Sorting out the complex issues may require a regular internal deliberative process between the agencies' staff. An important shared objective of both agencies would be to provide a means to inform the public of the agencies' shared views of the law and the character of various types of transactions. A more formal public process, such as notice and comment rulemaking or some other means to receive comment from interested parties, also might be warranted. Restricting the exemptive process to non-public requests and communications from particular interested parties involved in the offering of a digital asset in certain instances might be inadequate to inform the agencies of all of the potential impacts of an exemption or regulatory approach.[758]

An established process for resolving issues arising in the context of enforcement actions can be equally important to the development of consistent jurisdictional positions on which the public can rely. To the extent, for example, that the SEC considers a digital asset to be a security, it can be important that the CFTC both shares the SEC's view and believes the transaction does

[758] *See, e.g.*, 7 U.S.C. § 6(c)(1)(B) (not requiring public notice and opportunity for hearing for the CFTC and SEC's joint exemption of a product from SEC regulation of security futures).

not involve CFTC jurisdiction over a non-security commodity or derivative. Again, an ongoing, structured internal process for analyzing and resolving these issues could be beneficial.

In the end, the difficult jurisdictional issues ultimately could require congressional legislation to resolve. But legislation would benefit from collaborative work by the agencies between themselves and in a public comment process to identify and start to resolve how this area of commerce can be best regulated for the benefit of market participants and the development of innovative financial products that improve commerce.